

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 99-0630
Adjusted Gross Income Tax
For the Years 1992-1997**

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ISSUES

I. Adjusted Gross Income Tax-Net Operating Losses

Authority: Ind. Code § 6-3-2-2.6; 45 IAC 3.1-1-9; I.R.C. § 382.

Taxpayer protests the assessment of taxes based on the auditor's disallowance of net operating loss carryforwards after the taxpayer had merged with another company.

II. Tax Administration - Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2(b).

Taxpayer protests the imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer is a company engaged in heating, ventilation, air conditioning and refrigeration manufacturing and sales. Taxpayer filed consolidated returns for federal tax purposes for several years; however, taxpayer filed Indiana returns for only one entity with Indiana nexus for those years. Prior to 1988, taxpayer's predecessor was a publicly-traded corporation with significant net operating losses. In 1988, taxpayer's predecessor became a closely-held corporation. Between 1988 and 1991, taxpayer incurred further net operating losses, with some offsets. In late 1991, taxpayer's predecessor and another affiliated company merged to form taxpayer's present business. On taxpayer's Indiana corporate income tax returns, taxpayer carried over predecessor's net operating losses. On taxpayer's pro forma federal tax return for taxpayer, no net operating loss carryforward was shown.

Upon audit, the Department made several adjustments, including the disallowance of taxpayer's net operating loss carryovers from the predecessor. All other issues have been resolved with the exception of net operating loss carryovers and penalties, which taxpayer has protested.

I. Adjusted Gross Income Tax-Net Operating Losses

DISCUSSION

Taxpayer protests the imposition of adjusted gross income tax, and more particularly the disallowance of net operating loss carryovers after its merger. Ind. Code § 6-3-2-2.6 states:

(a) This section applies to a corporation or a nonresident person, for a particular taxable year, if the taxpayer's adjusted gross income for that taxable year is reduced because of a deduction allowed under Section 172 of the Internal Revenue Code for a net operating loss. For purposes of section 1 of this chapter, the taxpayer's adjusted gross income, for the particular taxable year, derived from sources within Indiana is the remainder determined under STEP FOUR of the following formula:

STEP ONE: Determine, in the manner prescribed in section 2 of this chapter, the taxpayer's adjusted gross income, for the taxable year, derived from sources within Indiana, as calculated without the deduction for net operating losses provided by Section 172 of the Internal Revenue Code.

STEP TWO: Determine, in the manner prescribed in subsection (b), the amount of the taxpayer's net operating losses that are deductible for the taxable year under Section 172 of the Internal Revenue Code, as adjusted to reflect the modifications required by IC 6-3-1-3.5, and that are derived from sources within Indiana.

STEP THREE: Enter the larger of zero (0) or the amount determined under STEP TWO.

STEP FOUR: Subtract the amount entered under STEP THREE from the amount determined under STEP ONE.

(b) For purposes of STEP TWO of subsection (a), the modifications that are to be applied are those modifications required under IC 6-3-1-3.5 for the same taxable year during which each net operating loss was incurred. In addition, for purposes of STEP TWO of subsection (a), the amount of a taxpayer's net operating losses that are derived from sources within Indiana shall be determined in the same manner that the amount of the taxpayer's income derived from sources within Indiana is determined, under section 2 of this chapter, for the same taxable year during which each loss was incurred. Also, for purposes of STEP TWO of subsection (a), the following procedures apply:

(1) The taxpayer's net operating loss for a particular taxable year shall be treated as a positive number.

(2) A modification that is to be added to federal adjusted gross income or federal taxable income under IC 6-3-1-3.5 shall be treated as a negative number.

(3) A modification that is to be subtracted from federal adjusted gross income or federal taxable income under IC 6-3-1-3.5 shall be treated as a positive number.

(4) A net operating loss under this section shall be considered even though in the year the taxpayer incurred the loss the taxpayer was not subject to the tax imposed under section 1 of this chapter because the taxpayer was:

(A) a life insurance company (as defined in Section 816(a) of the Internal

Revenue Code); or
(B) an insurance company subject to tax under Section 831

In effect, three prongs must occur for a deduction for net operating losses to offset Indiana adjusted gross income. First, a corporation must have incurred a net operating loss in a given year. Second, a corporation must have some portion of its Indiana adjusted gross income apportionable or allocable to Indiana for the year in which the net operating loss is incurred. Third, a corporation must have its adjusted gross income on its federal return reduced by a net operating loss for the taxable year in which it seeks to use the offset for Indiana purposes. Once a corporation meets these three prongs, the portion of the net operating loss deemed to be incurred to Indiana sources may be carried back and carried forward in the same manner as taxpayer may elect on its federal return. 45 IAC 3.1-1-9. If a corporation is deemed to have acquired a predecessor's net operating loss for federal tax purposes, then the net operating loss is treated as passing to the successor corporation for Indiana purposes as well. *Id.*

In this case, audit stated that taxpayer was not able to carry its net operating losses forward from 1992, after a corporate reorganization. In particular, the auditor noted that, due to the fact that taxpayer is a different corporation from the predecessor, the taxpayer was unable to carryforward its predecessor's net operating losses. The auditor also noted that I.R.C. § 382, which limits the use of certain tax attributes in the event of an ownership change, precluded the taxpayer's use of net operating loss carryforwards.

Relevant to this analysis is I.R.C. § 382(g). Under I.R.C. § 382(g), net operating losses are partially or totally limited if taxpayer experiences an increase of fifty percent of the aggregate shares owned by shareholders owning five or more percent of the corporation over a three-year period. In the merger, taxpayer's overall ownership did not change; instead, two predecessor corporations with common ownership merged. As a result, the taxpayer was able, within the meaning of federal law, to carry forward the net operating losses of its predecessor, and thus its carryover was otherwise permitted under Indiana law.

Taxpayer has maintained that its lack of carryover of net operating losses on its pro forma tax returns for the separate company failed to show the net operating loss because of an internal error in its preparation of those returns. Regardless of this issue, taxpayer has otherwise properly computed its net operating losses in accordance with Indiana law for the years in question.

FINDING

Taxpayer's protest is sustained.

II. Tax Administration-Penalty

DISCUSSION

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. Ind. Code 6-8.1-10-2.1. The Indiana Administrative Code further provides:

(b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

(c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

45 IAC 15-11-2.

Taxpayer's has provided sufficient information that its position was not negligent, but rather due to the exercise of reasonable care on the part of taxpayer.

FINDING

Taxpayer's protest is sustained.